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Anticipated Elimination of Barley Single Desk Casts Doubt on Contracts

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Report Highlights:
On April 21st 2007, Canada published its proposed regulations amending the Canadian Wheat Board (CWB) regulations, the purpose of which is to remove the CWB's monopoly (single desk) powers over inter-provincial and export trade in barley. The government has given August 1st, 2007 as the implementation date. With a global supply shortage and high market prices for barley, producers who have not yet delivered to the CWB may not honor their contracts with grain companies, thereby potentially forcing the latter to pay the current, higher, market price. Both the federal government and the CWB appear to be unwilling to force grains producers to honor their contracts, as doing so would risk alienating them before a possible upcoming national plebiscite on retaining the single desk for wheat. In addition to the Canadian and U.S. grain companies, their customers – Canadian and some U.S. malting companies – also stand to be adversely impacted by this situation.

Includes PSD Changes: No
Includes Trade Matrix: No
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Summary

On April 21st 2007, Canada published its proposed regulations amending the Canadian Wheat Board (CWB) regulations. The purpose of the regulatory amendment is to remove the CWB's monopoly (single desk) powers over inter-provincial and export trade in relation to barley. The CWB will retain its ability to operate pools, but barley producers will be able to sell their barley directly to any domestic or foreign buyer, including the CWB. The government has given August 1st, 2007 as the implementation date. Issues regarding liabilities and compensation for CWB contracts entered into before the regulatory changes were announced have yet to be addressed and were not part of the impact analysis statement.

Background

The Canadian Wheat Board (CWB) is a state-trading enterprise that has exclusive authority to handle all wheat, durum wheat and barley produced in the designated areas and destined for domestic consumption or export. The designated area is the western Canadian provinces of Manitoba, Saskatchewan, Alberta and the Peace River area of the province of British Columbia (B.C). First established by Parliament in 1935, the CWB was born in the depression era of the 1930s when unprecedented drops in the worldwide price of wheat resulted in bankruptcy for many farmers and threatened the economic collapse of provincial governments in Western Canada. The CWB attempts to stabilize the market for individual farmers, protecting them from unanticipated sharp fluctuations in the price of wheat and to prevent unexpected shocks to the Canadian economy. The CWB was set up as a pool system whereby farmers receive an interim payment and a final payment depending on the overall sales and prices. This pooling system provided Western grain producers with a pooled price, predictable cash flow and government guarantees if the Board's market forecasts were off the mark.

The make-up of western Canadian farms has changed significantly since 1935. At one time, farms were relatively homogenous, comprising mostly small, family-run operations. Wheat and barley produced on these farms was also homogenous in nature and so pooling to negotiate collectively with big agribusiness and the railways made sense. Western Canadian farms today are heterogenous, ranging from small-family farms to large and specialized and integrated agricultural operations. The demand side of wheat and barley has also changed to be more end-use specific and niche markets for specific types of barley and wheat have now been created. This diversity of product demand, and the potential to make a higher profit by marketing to a niche market, is harder to operate within a pooling system and has lead a large segment of farmers in Western Canada to lobby for the freedom to opt out of the CWB system completely.

The Conservative Party, which came to power in January of 2006, ran on a campaign platform which included the promise to give Western grain farmers the freedom to make their own marketing and transportation decisions. In July 2006, the Conservative government hosted a roundtable discussion to discuss options for implementing this commitment. In September of 2006, Canadian Minister of Agriculture, Chuck Strahl, created a taskforce with the mandate to develop and recommend options on how to bring about marketing choice for western grains producers. The purpose of this exercise was to chart a transition course that would allow the CWB to transition from an entity with single desk powers to a player in the open market. The aim was to outline how the CWB could remain a viable marketing option for producers, even without its monoply powers. The taskforce released its report in late October, 2006. It recommended a four stage transition process that begins with the disolution of the CWB's monopoly over barley as of February 2008, a timeline that would allow time for the market to prepare for the change.

A federal plebiscite on barley was held in March of 2007. The result of that plebiscite was that 62% of eligible voters voted in favour of wanting to be able to have a choice as to whom they market their barley. Shortly after the plebiscite results were announced, the Canadian government announced its intention to end the CWB single desk over western barley as of August 1st, 2007 – six months ahead of the Task Force's recommended start date for the transition process.

On April 21st 2007, Canada published its proposed regulations amending the Canadian Wheat Board (CWB) regulations. The purpose of the regulatory amendment is, effective August 1, 2007, to remove the CWB's monopoly (single desk) powers over inter-provincial and export trade in relation to barley. Within the cost/benefit section of the impact analysis, the government acknowledges that without its monopoly powers, the CWB may not receive sufficient barley deliveries to be able to honor the sales contracts signed before the regulatory change was announced. As a result, companies needing barley may have to pay higher prices in order to obtain barley from grain companies or directly from farmers. Questions regarding liabilities and compensation for CWB contracts entered into before the regulatory changes were announced were not part of the impact analysis statement.

Impact of Regulatory Changes

Canadian Wheat Board (CWB)

Shortly before the plebiscite results, the CWB made the announcement that without a full set of assets to replace its single desk powers for barley, it would be unable to add value to barley sales and would consider withdrawing from the marketing of barley for producers, should the plebiscite results favor marketing choice. With the April 21, 2007 gazetting of the proposed regulatory changes making the loss of the single desk a reality, the CWB Board of Directors is faced with many decisions regarding how to address the potential liabilities of the barley contracts negotiated before the announcement, and whether or not to continue marketing barley on behalf of western producers who wish to continue delivering to the Canadian Wheat Board. No official announcement has been made on what the Board's decision may be moving forward. While the proposed changes will remove the licensing powers of the CWB, the CWB retains its government guarantee of initial payments and its ability to operate pools.

On April 18th, 2007, the CWB release updated designated (malting) barley Pool Return Outlook (PRO) for the 2006/2007 crop year. The designated barley values were scaled down by C$8 per ton for both two-row and six-row varieties compared to the previous month's published values. This was done to take into account the likelihood of a reduced barley pool. They also suspended the 2007-2008 PROs and Producer Payment Options (PPOs) for both malting and feed barley stating that it is impossible to estimate a pool return at the current time.

Canadian Barley Producers

Industry contacts and other sources indicate that overall, barley producers are happy with the plebiscite results and the government's decision of an August 1st, 2007 implementation date. Most of the clashes between farm groups over the barley plebiscite seem to center on the process rather than the result. Canadian barley producers are in a strong position as world malt barley prices are high due to low malt barley production in Australia and the European Union, two of the three major global malting barley exporters. Canadian barley producers will likely hold off on delivering to the CWB if they think they may be able to get a better price by delivering to another buyer after August 1st, 2007. Prices for feed barley remain unaffected by the policy change, as there is already a free market for domestic feed barley.

Malting Industry and Grain Companies

The Canadian malting industry will be most affected by the short transition period imposed by an August 1st, 2007 implementation date. In order to secure supply, the malting industry may be faced with having to pay prices higher than CWB priced contracts negotiated before the regulatory change. The malting industry contracts 6 to 12 months in advance and therefore may have contracted a CWB price below current market prices that reflect the global malt barley supply shortage. The result is higher costs of production and increased liabilities. Importers of Canadian malt barley may also have to pay more to secure supply if not enough barley is delivered to the CWB malt barley pool.

While the CWB acts as a price-setting agent, it never physically handles the barley, and so it falls to the grain companies to expedite the contracts. The grain companies are in a similar situation to the malting industry as they are faced with the choice of canceling contracts, and possibly losing customers, or paying higher prices to Canadian producers to secure supply.

The malting industry and some of the major grain companies are insisting that the federal government push back the implementation date by a year to allow them a transition period to unwind their contracts in light of the new market conditions. They argue that until the August 1st 2007 implementation date, they are unable to contract with producers as, under the current law, only the CWB may contract with producers for barley for human consumption. Despite this constraint, industry sources indicate that some companies have found a creative way around this. Some companies are contracting directly with producers by promising them a guaranteed minimum price (which is above the current estimated CWB pool price) regardless of whether the CWB retains its monopoly over barley come August 1, 2007. Should the CWB lose its monopoly after August 1, 2007, the producer will receive market price.

Government

The Canadian government's current attempt to remove the single desk powers of the CWB on barley may prove successful. The changes being proposed will completely remove the regulations that extend Part IV of the CWB Act to barley (which was not done previously). Part IV of the CWB Act gives the CWB exclusive authority over the regulation of interprovincial and export trade in wheat subject to the Regulations. Reliable sources indicate that an August 1, 2007 implementation is likely to remain unchanged.

The government has published the proposed amendments in the Canada Gazette, Part 1, for a 30-day period. The proposed amendments will then be taken forward for final approval by the Governor in Council. Comments to the proposed amendments should be sent to Harold A. Hedley, Special Advisor, Canadian Wheat Board, Sectoral Policy Directorate, Strategic Policy Branch, Agriculture and Agri-food Canada, Sir John Carling Building, 930 Carling Avenue, Ottawa, Ontario, K1A 0C5, 613-759-6534 (telephone), 613-759-7476 (fax), headley@agr.gc.ca. The link to the proposed amendments is: http://canadagazette.gc.ca/partI/2007/20070421/html/regle1-e.html#i1

This is not the first attempt by a conservative government to remove the barley monopoly. In August 1993, Federal Agriculture Minister Charlie Mayer removed the CWB's single desk powers for barley in an attempt to create a continental barley market. A court challenge initiated by Saskatchewan Wheat Pool, a farmer-owned grain handling and elevator cooperative, resulted in a federal court ruling to have the change in the marketing structure reversed. The continental barley market existed for a period of 40 days.

FAS Analysis:

An implementation date of August 1st 2007 has created an incentive for barley producers to hold off on delivering on their contracts until August 1st 2007 when, should the CWB lose its monopoly, farmers will be in a position to take the higher prices in the open market. Industry contacts estimate that approximately 25% of the malting barley contracts have not been delivered (FAS has not been able to confirm this estimate with the Agriculture Canada or the CWB). While penalties for failure to deliver are built into the contracts, the higher market prices may more than offset the cost of not delivering. While the CWB has the ability to increase the penalties, this does not seem likely. Given the need for the CWB to continue to court its members in light of a possible upcoming national wheat plebiscite, the CWB is unlikely to act in such a way as to alienate western grains producers. As a result, producers who have delivered to the pool may end-up subsidizing the gains of those who choose not to deliver to the pool. After the government announcement, the CWB lowered the PRO for malting barley by 8$/ton.

The CWB role is that of a price-setting agent, leaving the grain companies to expedite the contracts. Due to this arrangement, what liability the CWB may have for the failure to deliver on signed contracts remains a gray area. If the CWB were to be found liable, given the somewhat unique asset structure of the CWB, it is difficult to ascertain what and if compensation would be possible. The CWB is not likely to act to ensure contract deliveries at the CWB price as to do so would require raising the initial price to farmers to reflect the higher world price. Doing so would incur costs that will put pressure on its asset structure. While the CWB has not stated whether or not it will continue to pool barley, it is likely that, due to the small volume of barley (compared to wheat) that the CWB handles, and, should the CWB lose its monopoly on barley, the CWB may completely withdraw from marketing barley in order to concentrate on marketing wheat. At present, there are no signs that the government is planning on implementing measures that will help the CWB transition to an open market for barley.

Those caught in the crossfire are the maltsters and the grain companies who now face increased costs as they scramble to secure barley supplies at world prices that have been driven up due to short supplies. Industry contacts estimate that it may cost “tens of millions” of dollars to replace the 2007/2008 contracted barley supplies. Grain companies and maltsters are unlikely to find sympathizers for their plight. Producers would like to take advantage of market prices and view the grain companies with suspicion, as trying to get around paying them current market value for barley.

Such a situation is also influenced by a minority federal government not willing to alienate its western voter base at a time when a federal election could be imminent. Nor does it appear that the federal government is likely to change the implementation date in the proposed regulations as the timing seems to dovetail with its political agenda. Current world prices for barley mean high returns for barley producers and a positive first time out experience for them in a completely free barley market. And a positive experience could, in turn, augur well for the results the federal government would like to see in the national wheat plebiscite it plans on holding. In addition, an extended implementation period could provide more time for CWB proponents to mount a counter-offensive. Lastly, the federal government views support for producers as simply good politics, with farmers and their families and the rural communities they support representing millions of votes.

On the balance, costs for the Canadian malting industry and costs of barley malt are likely to increase until new supplies from the EU and Australia hit the market. The high quality of the Canadian malt barley, which is due in large part to the Canadian Grains Commission (CGC), will ensure its continued demand. If grain companies are unable to renegotiate contracts in a way satisfactory to buyers, business relationships may suffer and take some time to rebuild. However, new buyers who had not wanted to have to contract through the CWB may now come forward. In a free market on barley, producers will have to ensure they develop and manage the relationships with their buyers.

Overview of Barley in Canada

While the United States remains Canada's largest export market for barley and barley malt (China ranks second), the make-up of barley exports to the U.S. has changed significantly over the last 20 years.

Domestic feed consumption is now the dominant use for barley produced in Canada. Exports of feed barley to the U.S. have decreased, mostly due to: (1) the elimination of the Western Grain Transportation Act subsidy; (2) the rapid expansion of the livestock sector in western Canada; and (3) intensified overseas competition from the EU, Ukraine and Russia. Over the last decade, yearly feed barley exports to the U.S. have averaged less than 100 thousand metric tons (TMT), or approximately 10% of total Canadian feed barley exports.

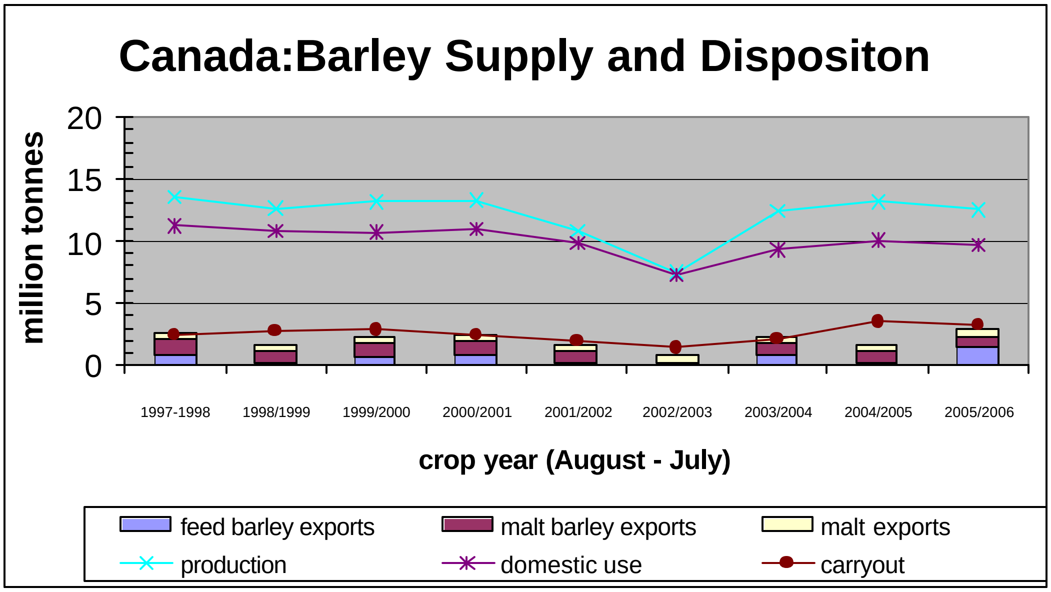
The U.S. is the world's second-largest beer producer, which makes Canadian malt barley and barley malt important. Canada is the third-largest malt barley exporter in the world, after Australia and the EU. Canada's low selection rate of malting barley of approximately 16% makes Canada a desirable source of high quality malting barley. Malting barley must meet a specific quality criterion that includes protein content, extraction rates, plumpness and germination. Between 2-3% of total barley supplies in Canada are used domestically for industrial production. This is mostly malting barley of which approximately 30% is used to produce beer while the remainder is used to produce barley malt for export.

Canadian malt barley exports to the U.S. at one time represented nearly 50% of total Canadian malt barley exports. However, the quantity of malt barley being exported to the U.S. has steadily declined since the year 2000. In 2005/2006, the U.S. imported 96 TMT of malt barley, or 11% of total Canadian malt barley exports. Although six–row barley accounts for nearly 80% of the US malting barley market, increased production of two-row malting barley and increased processing capacity in the U.S. mid-west, as well as higher selection rates is contributing to the downward trend of Canadian malt barley exports to the U.S.

While malting barley exports to the U.S. may be trending downwards, barley malt exports to the U.S. have shown a steady increase over the past 10 years. In the year 2005/2006, Canada exported 176 TMT to the U.S. The U.S. share of malt exports coming from Canada was more than one third of total barley malt exports from Canada.

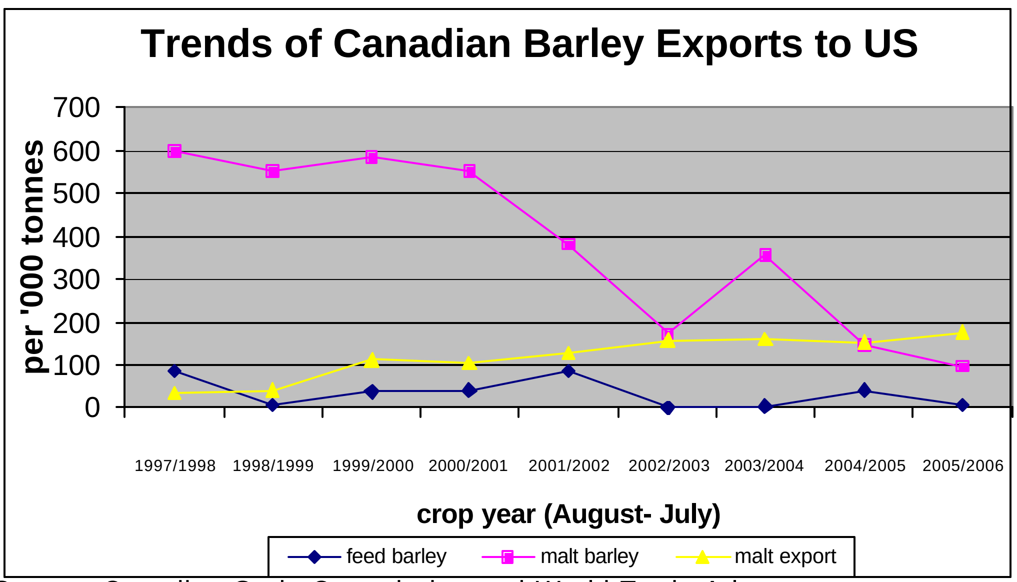
Figure 1 on the following page provides a snapshot of the Canadian barley supply and disposition. Figure 2 depicts the trend of export to the U.S.

Figure 1:



Source: Canadian Grains Commission and World Trade Atlas

Figure 2:



Source: Canadian Grain Commission and World Trade Atlas